

## **Module B**

# **Introduction to Federal Taxation of Municipal Bonds**



## Module B

### Introduction to Federal Taxation of Municipal Bonds

#### Overview

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**Introduction** This module provides an introduction to federal taxation of municipal bonds. It focuses on IRC section 103 and its relationship with sections 141-150. It will give you a map for your audit plan, and also provide an overview of the entire course.

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**Objectives** At the end of this module, the student will be able to:

1. Explain the provisions of IRC section 103.
  2. Differentiate between a governmental and a private activity bond.
  3. Define a qualified private activity bond.
  4. Define arbitrage.
  5. Identify the provisions of IRC section 149.
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**In this module** This module contains the following topics:

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## IRC section 103

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### General provisions

When considering whether or not the interest on a municipal bond is taxable or tax-exempt, the starting point is IRC section 103.

IRC section 103 consists of three main provisions:

- 1) IRC section 103(a) generally provides that the interest on state and local bonds will not be included in the gross income of the recipient, AS LONG AS THE BONDS ARE NOT IDENTIFIED IN IRC SECTION 103(b).
- 2) IRC section 103(b), identifies those types of bonds the interest on which WILL BE TAXABLE to the recipients.
- 3) IRC section 103(c) provides definitions of:
  - *state or local bonds*, and
  - *state*.

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### Importance of IRC section 103(b)

The provisions of IRC section 103(b) are most important because if the bond is described in this section, then the interest is NOT tax-exempt. IRC section 103(b) includes the following types of bonds:

- Private activity bonds - as described in IRC section 141 - which are NOT qualified bonds.
- Arbitrage bonds - as described in IRC section 148.
- Bonds that do NOT meet all of the requirements of IRC section 149.

The next three sections will discuss each of these types of bonds.

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# Governmental Bonds

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## **Governmental bonds vs. private activity bonds**

There are two main types of bonds:

- governmental bonds and
- private activity bonds.

Distinguishing between the two is important for the following reasons:

- the interest on governmental bonds is tax-exempt, while the interest on private activity bonds GENERALLY is not. (More on this later.)
- some rules apply only to governmental bonds, while others apply only to private activity bonds. Others apply to all bonds, regardless of the type.

For example, the rules of IRC sections 146 and 147 (Modules J and K) apply only to certain private activity bonds, while the rules of IRC section 149 (Module C) apply to ALL bonds.

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## **Governmental bonds**

Governmental bonds are obligations issued by a governmental unit (or other entity) to finance governmental operations. These bonds are issued by a municipality for its own purposes. For example, a county can issue bonds and expect to use the proceeds to:

- build or renovate a building which the county itself will use,
- build, repair and/or maintain schools and roads,
- build and operate a county-owned power plant or sewage treatment facility.

Two distinguishing characteristics of governmental bonds are that the bond proceeds:

- will be USED by the governmental entity for its own purposes, and
  - the bond-financed property will be OWNED by the governmental unit.
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## **Where is the definition of governmental bonds?**

The Code does not define governmental bonds. Rather, bonds are treated as governmental and the interest thereon is tax-exempt unless a prescribed amount of the bond proceeds is used for activities of nonexempt persons.

IRC section 103 does not mention governmental bonds, but it does refer to private activity bonds. The tests of section 141 are used to distinguish between governmental and private activity bonds.

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# Private Activity Bonds

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## Private activity bonds

Generally, private activity bonds are bonds issued by a governmental unit (or related entity):

- the proceeds of which will be used by an entity OTHER THAN a governmental unit, AND
- the debt service of which will be paid from private payments.

For example, a for-profit hospital system may approach a municipality about issuing bonds because the system wants to construct a new wing. The municipality would issue the bonds, and loan the proceeds to the system. The system would use the proceeds to construct the wing, and repay the loan from hospital income. Assuming that these bonds would not meet any of the sections that provide for *qualified private activity bonds*, these bonds would be private activity bonds, and the interest would be taxable. (Qualified private activity bonds are a specific type of private activity bond which will be discussed shortly.)

Sometimes private use and payment are not obvious. For example, a municipality may issue bonds to finance a government office building, and then meet the tests through an operating or lease agreement.

A bond cannot be a governmental bond and a private activity bond at the same time.

IRC section 141 provides the tests for private activity bonds. If a bond meets the other requirements, but not the section 141 tests, then it probably is, by default, a governmental bond.

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## Private Activity Bonds, Continued

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### **IRC section 141: private activity bond tests**

IRC section 141 provides two main tests for private activity bonds. If either test is met, then the bonds are private activity bonds - and the interest on the bonds could be taxable. These tests are:

- private business tests, and
- private loan financing test.

If an issue does not meet either of the tests, then it is probably a governmental bond.

These tests will be discussed in more detail in Module D.

Once a bond has been determined to be a private activity bond, there is still a chance that the interest can be tax-exempt. That is, if the bonds meet the requirements of a *qualified private activity bond*.

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# Qualified Private Activity Bonds

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## **Qualified private activity bonds**

Qualified private activity bonds are bonds that are private activity bonds because the tests of IRC section 141 are met. But as long as certain other requirements are met, the interest on the bonds is still tax-exempt. Even though the proceeds of qualified private activity bonds are used by private entities, that use is considered to be a “good” use.

These may be services that municipalities need, but for one reason or another, cannot provide. So, an inducement in the form of tax exempt financing is provided to other entities.

For example, municipalities need hospitals. But few municipalities have the time and expertise to operate a hospital. There are many section 501(c)(3) organizations that know how to operate hospitals, and they could borrow funds from a municipality to construct a hospital. The section 501(c)(3) organization would be providing a community service and lessening the burden of the municipality. These bonds would be considered to be qualified private activity bonds, and the interest would be tax-exempt.

Another example focuses on power plants. Cities need power plants, but some lack resources to operate them. Tax-exempt bond proceeds provide a subsidy to those organizations (whether for-profit or nonprofit) who choose to provide these services.

Qualified private activity bonds also include those issued for “exempt facilities” such as airports, docks, wharves, and mass commuting systems, as well as water, sewage, and solid waste disposal facilities. Qualified private activity bonds can also be issued for residential mortgages, small industrial development projects, student loans, redevelopment projects, and charitable purposes.

IRC sections 142 through 145 provide for various types of qualified private activity bonds. Qualified private activity bonds are discussed in Modules E through I. Additional requirements for qualified private activity bonds are discussed in Modules J and K.

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## Qualified Private Activity Bonds, Continued

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### **Change in use after issuance**

The tests of IRC section 141 begin on the date of issuance of the bonds, and must be continually applied as long as the bonds are outstanding. For example, the tests are applied when bond-financed property experiences a change in use or ownership sometime after issuance.

When a change in use of bond-financed property occurs after the issuance date - but while the bonds are still outstanding - this change can sometimes affect the tax status of the interest on the bonds causing the interest to become taxable retroactively to the issuance date.

The ramifications of these changes in use are discussed in Module L. These rules are particularly important to examination agents because agents will be verifying the status of the bonds long after the issuance date. Part of the audit plan will be to verify that the bonds are still being used for their intended purpose.

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# Arbitrage Bonds

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## Introduction to arbitrage

You will recall from reading IRC section 103(b) that the interest on a municipal bond cannot be tax-exempt if the bond is an arbitrage bond.

Although ALL types of bonds are subject to the arbitrage restrictions, different rules apply to the various types of bonds.

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## Definition of arbitrage

*Arbitrage* is the purchase and sale of the same or equivalent security in order to profit from price differences. The term *arbitrage* is not exclusive to municipal securities; it applies to all types of investments.

### Example

Suppose City A has an excellent credit rating and can borrow \$1,000 on the tax-exempt market for three years at 6% interest. If marginal tax rates are 25%, this obligation would provide equivalent after-tax income as a similar taxable obligation that bears 8% interest. City A decides to invest the \$1,000 that it borrowed by purchasing an equivalent taxable note bearing 8% interest issued by a corporation that also has an excellent credit rating. Each year, City A receives \$80 and pays only \$60 allowing for \$20 profit. Because City A is not subject to federal income tax, it can keep the entire \$20 each year.

This *tax arbitrage* arises from the effect of the interest exclusion under IRC section 103, which causes a difference between the taxable and tax-exempt markets.

This type of investment activity is precisely what IRC section 148 prohibits.

### Example

Suppose a farmer sells corn in Village A for \$5 per bushel. A restaurant owner in City B, located 50 miles away from Village A, buys corn in City B for \$10 a bushel. A trucker is willing to transport corn from Village A to City B for \$3 a bushel.

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## Arbitrage Bonds, Continued

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### Definition of Arbitrage, continued

If you simultaneously enter into contracts to:

- buy corn from the farmer for \$5,
- sell the corn to the restaurant owner for \$10, AND
- to transport the corn for \$3

you would realize a \$2 profit on each bushel.

That \$2 profit is called *arbitrage*, which in this case arises from the difference between two geographically separate markets.

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### IRC Section 148

The arbitrage rules have two main parts:

- restriction of investment of bond proceeds at a yield that is “materially higher” than the bond yield, (“yield restriction”) AND
- rebate to the federal government of any arbitrage profits that are earned (“rebate”).

The yield restriction basic rule is set forth in section 148(a) where arbitrage bonds are defined as any bonds issued which are reasonably expected to be used to:

- acquire higher yielding investments, OR
- replace funds that were used to acquire higher yielding investments.

The rebate requirement is provided in section 148(f) which provides that whenever certain bond proceeds are invested at a yield above the bond yield, these earnings must be paid (“rebated”) to the United States.

The yield restriction rules are based on “reasonable expectations” on the issuance date, while the rebate requirement is based on actual investment. Therefore, some proceeds may not be subject to yield restriction, but still be subject to the rebate requirements.

As you can guess, both parts have many complex rules and exceptions.

Module M provides a more detailed discussion of arbitrage, while Module N covers rebate requirements.

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# Requirements of IRC Section 149

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<b>Introduction</b>	IRC section 103(b)(3) states that the interest on bonds which do not meet the applicable requirements of section 149 will be taxable. Therefore, ALL types of bonds are subject to these rules, although some rules may have limited applicability.
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<b>Provisions of IRC section 149</b>	<p>IRC section 149 contains the following provisions regarding tax-exempt bonds:</p> <ul style="list-style-type: none"><li>• registration</li><li>• federal guarantees</li><li>• treatment of bonds receiving their tax-exempt status from statutes other than the Internal Revenue Code</li><li>• advance refundings</li><li>• reporting requirements</li><li>• pooled financings</li><li>• hedge bonds.</li></ul>
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All of these provisions are discussed in Module C. Additionally, Phase II of this training contains more information about the following topics:

- advance refundings
  - pooled financings.
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# Auditing Techniques

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## Introduction

The examination of a tax-exempt bond issue is very similar to the examination of a tax-exempt organization. Both types of examinations require the examiner to:

- verify qualifications for continued tax-exemption, AND
- determine if there is any tax liability associated with the bonds.

Although the examination processes are similar, there are some differences, such as:

- the issuer of the bonds must be a governmental unit. As such it does not file tax returns to pay or pay income taxes. Nevertheless it is treated as a taxpayer for purposes of the Code
  - although initial contact is made with the issuer, the issuer is often NOT the taxpayer involved in the transaction. Often the issuer loans the bond proceeds to another taxpayer called the conduit borrower
  - often the issuer does not maintain the records pertinent to the examination; these must be obtained from the conduit borrower
  - bond examinations possess special disclosure concerns
  - special closing procedures are used for bond examinations
  - there is more extensive involvement of National Office and District Counsel staff
  - there is more potential for use of a summons to obtain information.
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## Bond information return

When you are assigned a bond issue for examination, you should receive a Form 8038 series report. This information return is filed by the issuer on or shortly after the issuance date of the bonds. It will tell you basic information about the issue, including the type of bond. If the issue was classified as a qualified private activity bond, the form will indicate the Code section under which the issue was classified. Your goal during the examination is to verify that the bonds should continue to maintain this classification. If not, you must determine whether the interest on the bonds remains tax-exempt. **(See Exhibits B-1 and B-2 for Forms 8038 and 8038-G and instructions.)**

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## Integration of audit techniques

Throughout the course, appropriate audit techniques are introduced and discussed. Module O contains a detailed discussion of audit techniques, as well as a comprehensive case problem.

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# Summary

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## Review of Module B

IRC section 103 provides the foundation for the income exclusion of interest of municipal bonds. Because the exclusion from income is a general provision, the exceptions become much more significant.

Recall that section 103 identifies three different types of bonds the interest of which will be taxable. These three types of bonds are:

- private activity bonds that are not qualified,
- arbitrage bonds, AND
- those that do NOT meet the applicable section 149 requirements.

Module B introduced each of these concepts by discussing the following:

- governmental bonds, private activity bonds, and qualified private activity bonds,
- yield restriction and rebate are the two main parts of the arbitrage rules, AND
- the provisions of section 149.

ALL of these concepts will be discussed in greater detail later in the text.

**Figure B-1** illustrates the concepts discussed in Module B, as well as some of the decisions which must be made regarding bond issues. Note that this is a very general guide, and is NOT inclusive enough to be used as an audit plan.

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## Summary, Continued

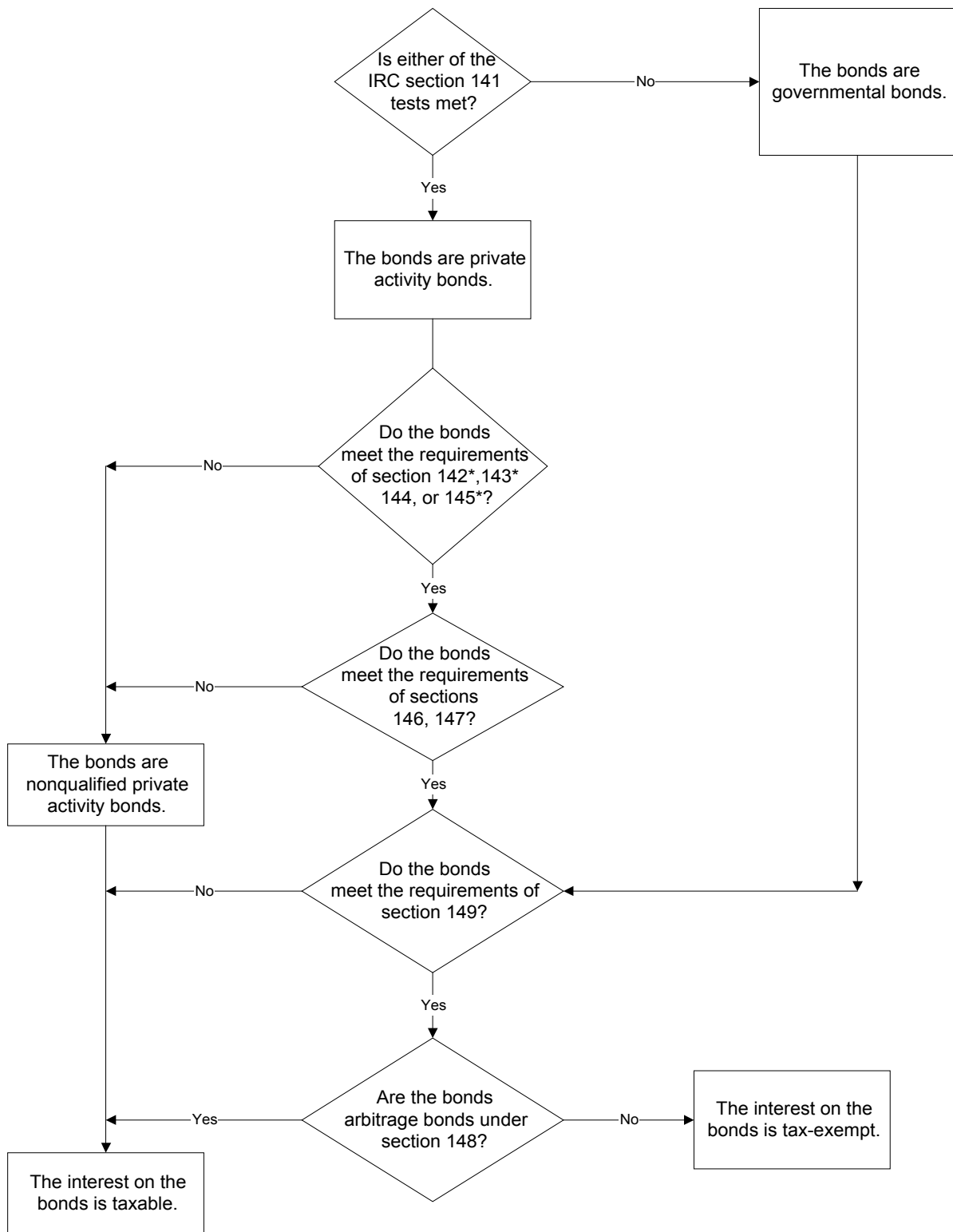
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**Preview of text** The remainder of this text builds on the concepts presented in Modules A and B. The text concentrates on the three exceptions of section 103(b). The terminology and techniques presented in Module A will be used throughout the text.

You will learn:

- the provisions of section 149, and how they apply to all types of bonds,
  - how to identify a private activity bond,
  - the requirements of qualified private activity bonds,
  - the applicable rules when a change of use occurs,
  - other requirements applicable only to certain types of qualified private activity bonds,
  - how to compute bond yield and determine if the yield on the investments is materially higher than the bond yield
  - exceptions to yield restriction,
  - rebate requirements and exceptions, AND
  - auditing techniques.
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FIGURE B-1: GENERAL PROVISIONS OF IRC SECTION 103



\*IRC sections 142, 143 and 145 contain modifications to the private activity tests of IRC section 141.



## Class Exercises

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**Exercise 1** IRC section 103(a) provides a general exclusion from gross income for the interest on state and local bonds.

**Question:** What three types of bonds are excluded from tax exemption by section 103(b)?

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**Exercise 2** Indicate whether the following bond issues issued by City A would be classified as governmental or private activity bonds.

- bond proceeds used to construct a pavilion in City A's park
  - bond proceeds used by a for-profit entity to provide local electricity
  - bond proceeds used to renovate a city-owned building, which will be leased to a retail organization
  - bond proceeds used by a section 501(c)(3) organization to construct an office building to be used as its headquarters.
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**Exercise 3** What are the two main parts of the arbitrage rules?

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## **Class Exercises, Continued**

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### **Exercise 4**

You are assigned the examination of Bond Issue 1 issued by County A. The Form 8038-G indicates that the bonds are governmental bonds. Indicate whether or not the following procedures should be included in your audit plan:

- private activity bond tests of IRC section 141
  - compliance with IRC section 149
  - compliance with IRC section 146
  - compliance with IRC section 147
  - analysis of invested proceeds to determine the yield.
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END OF MODULE B